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The Covid-19 pandemic continues to cause significant health and economic challenges around the world. Global activity fell sharply during the first few months of 2020. Since then, output has recovered, but remains below levels at the start of the year.

The Bank's policy committees have taken complementary actions in response to the pandemic. These actions have helped households and companies through the economic disruption caused by Covid-19, and have helped to minimise its longer-term economic consequences. Nevertheless, the scale of the shock and the measures necessary to protect public health mean that a significant loss of economic output has been inevitable.

The impact of Covid-19 on the economy

Activity fell sharply around the world in March and April, as social distancing affected spending. UK-weighted global GDP is estimated to have fallen by around 12% over the first half the year. While substantial, that fall is materially less sharp than assumed in the illustrative scenario in the May *Report.* That reflects restrictions being eased sooner than assumed and, even while some restrictions remained in place, a more rapid recovery in consumer spending.

The timing and magnitude of the falls in activity have varied across countries, partly reflecting differences in the spread of the virus and lockdown measures, including when they began to be eased. In the UK, relative to some other countries, lockdown measures were eased later and the proportion of spending involving high degrees of social interactions is bigger in normal times. As a result, the impact of Covid-19 on UK activity has been relatively large. UK GDP is expected to have been over 20% lower in 2020 Q2 than in 2019 Q4.

Global activity has strengthened over recent months, although it generally remains below its level in 2019 Q4. Covid-19 has continued to spread rapidly within a number of emerging market economies, and there has been a renewed rise in cases in many advanced economies.

In the UK, GDP rose in May, and higher-frequency indicators suggest that spending has recovered further since then. The recovery has not been evenly distributed across the economy, however. Consumer spending on items that can be delayed, such as clothing and furniture, has recovered strongly, and spending on staples such as food has been above pre-Covid levels. Spending that involves high levels of social interactions has remained subdued, however, and evidence from surveys suggests that business investment has remained weak. The weakness in these types of spending will partly reflect measures introduced by the Government to slow the spread of the virus, as well as heightened uncertainty about health risks and the economic outlook.

Employment appears to have fallen since the Covid-19 outbreak, although this has been very significantly mitigated by the extensive take-up of support from temporary government schemes. The Coronavirus Job Retention Scheme (CJRS) and Self-Employment Income Support Scheme (SEISS) have been widely used. Bank staff estimate that around 6 million employees were furloughed on average during Q2 and around 80% of eligible self-employed workers made use of the SEISS.

The supply capacity of the economy has fallen, as businesses have shut and employees have been furloughed. Around 7% of businesses reported that they remained closed in July, and others have temporarily reduced production and furloughed employees. The balance between demand and supply is difficult to gauge, but on balance the MPC judges that there is a material degree of spare capacity at the moment.

Inflation has been very weak, largely reflecting the direct and indirect effects of Covid-19. Spare capacity will have exerted some downward pressure on domestic prices. In addition, CPI inflation has been affected by lower energy prices, as oil prices fell markedly in response to the fall in global GDP. That accounts for a large part of the fall in inflation from 1.7% in Q1 to 0.6% in Q2.

The MPC's latest projections

The outlook for the UK and global economies remains unusually uncertain. It will depend critically on the evolution of the pandemic, measures taken to protect public health, and how governments, households and businesses respond to these.

In the MPC's projections, heightened uncertainty about the outlook for both health and the economy is assumed to wane, but only gradually. The path for uncertainty is consistent with rising prospects of improved treatments or other health interventions becoming available over time. Over the forecast period, those developments are assumed to reduce the health and economic risks facing households and businesses, such that the direct effects of the pandemic on the economy fade.

Spending in the UK is projected to rise over the second half of the year, consistent with recent developments in high-frequency indicators. At the end of this year, GDP is projected to be 5% below its level a year earlier.

Over 2021, spending is projected to remain weaker than it would have been in the absence of Covid-19. Caution over the outlook for health and the economy fades only gradually, so it continues to dampen spending. Tighter financial conditions also weigh on output. In the MPC's central projection, GDP does not exceed its level in 2019 Q4 until the end of 2021. Over 2021, GDP is, on average, more than 3% weaker than in the MPC's January forecast.

The Covid-19 shock has a persistent effect on the supply capacity of the economy, due to lower investment and reduced innovation. Tighter credit conditions also impair productivity by reducing how efficiently capital is allocated across the economy. Consequently, the supply capacity of the economy is projected to be around 1½% lower than it would have been in the absence of Covid-19 by the end of the forecast period.

The weakness of activity in the second half of 2020 is likely to continue to be reflected in a material amount of spare capacity in the economy. Unemployment is expected to peak at around 7½% in 2020 Q4 before declining. That decline is gradual, however, as uncertainty affects companies' demand for labour and the efficiency with which people can find jobs is reduced.

CPI inflation is expected to fall further below the 2% target and average around ¼% in the latter part of the year, largely reflecting the direct and indirect effects of Covid-19. These include the impact of energy prices and the temporary cut in VAT for hospitality, holiday accommodation and attractions.

As these effects unwind, inflation rises, supported by a gradual strengthening of domestic price pressures as spare capacity diminishes. In the MPC's central projection, conditioned on prevailing market yields, CPI inflation is expected to be around 2% in two years' time.

Given the inherent uncertainties regarding the evolution of the pandemic, the MPC's medium-term projections are a less informative guide than usual. That uncertainty is reflected in the MPC's forecast fan charts, which are wider than usual.

The MPC judges that the risks to the path for uncertainty in the forecast are skewed towards the downside for activity. Greater concerns about health outcomes, for example, would be likely to result in less social spending by households. It could also result in greater long-lasting effects on the supply side of the economy.

The MPC's policy decision

Monetary policy cannot prevent the losses of revenue and income that companies and households suffer as a result of the pandemic, but it does have a role in supporting the economy and aiding the recovery. In doing so, monetary policy helps to limit any longer-term damage to the economy.

The Committee judges that the existing stance of monetary policy remains appropriate.

The Committee will continue to monitor the situation closely and stands ready to adjust monetary policy accordingly to meet its remit. The MPC will keep under review the range of actions that could be taken to deliver its objectives. The Committee does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

The FPC's assessment

Companies continue to face a severe cash flow shock, and many will require further finance to bridge through this disruption and minimise the impact on employment and productive capacity. The FPC estimates that in the MPC's central projection, and taking into account the material support provided by the Government's fiscal measures, UK companies could face a cash-flow deficit of up to around £200bn in the current financial year.

The UK financial system has met most of the initial surge in demand for credit, supported by the extraordinary policy responses of the Government and Bank of England. Net finance raised by UK companies from banks, primarily through the Government-backed loan guarantee schemes, exceeded £70 billion since the start of the Covid-19 pandemic.

While the number of corporate insolvencies has remained low to date, it is likely to increase. Some companies may struggle because they were highly leveraged or unprofitable at the outset of the Covid-19 shock, and others may face pressures because of structural changes in the economy. Unemployment is expected to rise.

UK households entered the Covid-19 shock in a stronger financial position than before the global financial crisis. Payment holidays and government schemes are continuing to support household finances, but the sharp fall in economic activity has put pressure on many households' incomes, and as support begins to unwind in the second half of the year this is likely to reveal underlying vulnerabilities in some households.

The FPC continues to judge that banks' capital buffers are more than sufficient to absorb the losses that could arise under the MPC's central projection.

The banking system cannot be resilient to all possible outcomes – there are inevitably very severe economic outcomes that would challenge banks' ability to lend. Defensive actions by banks may be necessary in stress, but only if there is a material probability of the economy following a path so severe that it might jeopardise banks' resilience.

The FPC has carried out a "reverse stress test" to analyse how much worse than the central projection the economic outcome would need to be to jeopardise banks' resilience and challenge their ability to lend to the wider economy.

To deplete banks' regulatory buffers of capital as much as in the 2019 stress test that was used to set their requirements, banks would need to incur £120bn of credit losses. To generate that, the cumulative loss of economic output from the disruption associated with the Covid-19 outbreak would need to be around twice as big as in the MPC's central projection, and be accompanied by a significant rise in unemployment to around 15%. Even then, banks would have space to absorb a further £80bn of losses in their capital buffers, as they hold larger capital buffers than required by regulation.

Based on this exercise, the FPC judges banks to be resilient to a very wide range of possible outcomes. Banks have the capacity, and it is in their collective interest, to continue lending to businesses and households including to refinance existing debt, even in a severe economic downturn. This will help avoid forcing viable companies into insolvency, which would result in higher losses to lenders and a more persistent downturn.

The FPC has also identified the need for further work to review the resilience of market-based finance and the appropriate balance between private sector resilience and reliance on central bank liquidity support in a financial market liquidity stress, in light of the dysfunction in key markets experienced in March.

The financial system is reliant on government bond and repo markets remaining liquid in stress. In March, these markets were threatened by a "dash for cash", which highlighted a number of vulnerabilities in market-based finance the FPC has previously identified. Central bank interventions were necessary and effective in avoiding wider economic damage, but such interventions can pose risks to public funds and can encourage excessive risk taking by investors.

Recognising the global nature of the markets, this work needs to be internationally co-ordinated, and the FPC welcomes the work by the Financial Stability Board (FSB) to undertake a comprehensive review of the provision of market-based finance in light of the Covid-19 shock.